

## The Trader's Tax Edge: Mark-To-Market.



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Although recent tax laws have given active traders certain advantages when filing taxes, you can't benefit from them if you don't understand them. Here's a look at the bottom-line effect of using the "mark-to-market" election.

I am often asked by active traders what the benefits are of making a Section 475 (mark-to-market) election. The answer I usually give them is, "it depends."

If an active trader trades ANYTHING and has a loss greater than \$3,000 in any one year, the benefits of electing 475 are tremendous. If an active trader shows a gain, there are still some benefits to the election, but there may also be a downside if those gains come from trading either commodities or OEX options-known as Section 1256 contracts. Declaring mark-to-market would negate the benefits of this type of income.

Also, there is the possibility of having an unrealized gain in your position at year end, which would have to be in marked-to market. This would result in taxable income from open positions. Other than those two factors, there is really no downside to the 475 election, and the potential for many benefits remains. An advantage to electing Section 475 is there is no wash-sale consideration on a mark-to-market election. Usually, an active trader who buys and sells the same stock or option on a regular basis would have to defer any loss taken on a trading vehicle he or she sold and then purchased again within 30 days. A trader who elects Section 475 does not have to worry about this compliance.

In 1997, Congress somewhat redeemed the active trader. The tax act put into law that year contained a landmark section that placed active traders in an even more advantageous position than professional floor traders. With the inclusion of sections 475 (e) and (f) in the new law, traders had the opportunity to elect Section 475 and to treat all losses as ordinary.

Further, in December 1997, the Joint Committee on Taxation issued the Blue Book explaining the new tax law. This report states that, for the first time, trading income is not subject to self-employment tax. (That position has been tempered by the fact the IRS still considers the income to be self-employment income if the trader is operating from the floor of an exchange.) This report, though, will hopefully end the discussion I have been having for years with most of my colleagues, IRS officials and many traders misinformed by erroneous information given to them by their (many times, former) accountants.

The good news is that the Blue Book states: "Congress intended that the gain or loss that is treated as ordinary solely by reason of the (475) election would not be treated as....net earnings from self employment..."

The bad news is that once the IRS got wind of this, they promptly tried to close the barn door before any more horses got away. Constraints on the 475 election were recently enacted by an IRS Revenue Procedure issued in March of last year (Rev.Proc.99-17).

### Table 1 The 475 (“Mark-To-Market”) Election: Pros and Cons

A breakdown of the advantages and disadvantages of a 475 election.

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#### ADVANTAGES

- \*Take loss as ordinary
- \*No Wash Sale Consideration
- \*Can carry back losses to prior years
- \*Must comply with strict time deadlines and format

#### DISADVANTAGES

- \*Must take unrealized gains, if any at years end.
  - \*Do not get long term capital gain treatment for commodities & OEX options.
  - \*Election is permanent unless you apply for a rescission.
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#### Electing mark-to-market

You MUST elect mark-to-market by the time the previous year’s tax return is either filed or extended, whichever comes first. What this means is that to elect section 475 for the year 2000, the election must have been made by the filing date of the 1999 tax return or the date the return was extended. (If the date is missed, the only way to elect Section 475 for the year 2000 is to set up a new entity- i.e., a corporation, LLC, or partnership- and trade through it.)

A statement must be attached to last year’s extension (or tax return), indicating you have decided to elect Section 475 this year. The statement we use is something along the lines of this: Election for mark-to-market accounting treatment for traders in securities and commodities for tax year (\_\_\_\_): Taxpayer is engaged in business as a trader in securities and commodities. The taxpayer herewith elects mark-to-market accounting treatment for traders in securities and commodities pursuant to IRC Sec.475 (F) (1) and (2). This election is made in accordance with IRS revenue procedure 99-17 for tax year (\_\_\_\_) and for its business as a trader in securities and commodities. Income and expenses for this business will be reported on Form \_\_\_\_\_ (whatever tax form the return is filed on –e.g.,1120 for corporations).

Accordingly, the taxpayer records both realized gains or losses for the year, and any unrealized gains or losses on open security positions held on 12/31/\_\_\_.

Furthermore, in connection with its trading business the income is reported as ordinary income. The unrealized gains and losses are recognized at the close of the taxable year as if such security were sold for its fair market value on the last business day of the year. Proper adjustment to the cost basis will be made for any gain or loss subsequently realized. Taxpayer agrees to all the terms and conditions in revenue procedure 99-17.

When the actual return is filed, in most cases, a Form 3115 must be included with the return. There are some exceptions when a form 3115 does not have to be filed, but in most instances, it formalizes the election. The 3115 is a very complicated form, and must be filed in duplicate. If it is not filled out properly, or not filed on a timely and accurate basis, the 475 election will be nullified.

I strongly suggest consulting with a tax professional familiar with this procedure rather than trying to do it yourself. What you pay the professional will be worth it, as he or she will be able to get you deductions you might miss on your own.

The Significance of a 475 election to a trader with a loss

Let's look at an example using a taxpayer with the following following set of circumstances:

- Trading /Investment loss: \$100,000
- Other income as follows:
- \*Salary: \$200,000
  - \*Real Estate Income:\$200,000
  - \*Investment/Trading Expenses:\$200,000
  - \*Estimated tax payments made:\$100,000

Looking at the form 1040 of someone who does not have a Section 475 Election (above), you will note several things first. First of all, (on Line 13-capital gain or loss), you would see that of the \$100,000 loss, only a \$3,000 deduction was allowable.

By comparison, Sample #2 would show Form 1040 of a trader who has elected 475. On the same line, there is no capital loss deduction. Instead, the full loss(\$100,000) is added to trading expenses and marked as a \$299,178 deduction on line 12 (Business Income/Loss). This is because a trader making the 475 election has now transformed a capital loss (limited to \$3,000) into a fully deductible business loss.

Additionally, much of the trading expense could not be deducted by someone who is an investor (as opposed to a trader) in the eyes of the IRS. For a trader, these expenses are deductible "above the line," and many more expenses can be taken in any one year.

Sample #3 and #4 Scenario would show the other differences that result from electing 475 and trader status .On line 36 of Scenario #3 (the 2<sup>nd</sup> page of the investor's Form 1040), you would see that out of the \$199,178 taken as ordinary deductions for the trader, the investor got to deduct only \$78,827.

In Scenario #4 (the 2<sup>nd</sup> page of the trader's Form 1040), line 36, you will notice the trader received the standard individual deduction of \$4,250 in addition to the \$199,178. There will also be no Alternative Minimum Tax for traders, whereas many investors will

be subject to it (line 51, Scenario #3 and #4). A trader in this case also will be entitled to a \$2,700 exemption, where an investor will not, because of an income-based phase-out (line 38, Scenario #3 and #4). If you would check Scenario #3 (line 68) and 4 (line 66a), you will see the difference in tax. As an investor not filing with a section 475 election, the taxpayer would owe another \$7,660 in tax. This is in addition to the \$100,000 paid in estimates throughout the year. By contrast, as a trader filing with a section 475 election, the taxpayer would get back more than \$76,000 in tax refunds. This swing of \$83,660 in Federal Tax between an investor not electing Section 475 and a trader who does clearly shows the significance of the Section 475 election.

Again, please keep in mind that this is a very complicated section of the code and I strongly suggest you consult with your tax professional prior to doing this yourself.

## Glossary

### Capital asset:

Property that is not held for inventory or for sale to customers. In this context, it is an asset such as a stock, option or commodity.

### Capital gain income (loss):

The income (loss) realized on the sale of a capital asset. Long-term capital gain income (on capital assets held a year or more) is taxed at a maximum 20 percent rate.

### Ordinary gain (loss):

The gain or loss generated from the sale of a non-capital asset. The rate of taxation is the taxpayer's ordinary tax rate-as high as 39.6 percent.

### Mark-to-market:

The process of taking an open position at year-end and treating it as having been sold even though the position may still be open. The result of this is the recognition of income or loss (for tax purposes) on positions that are not yet closed out.

### Section 1256 contract:

A commodity or OEX index option that is taxed in a preferential manner: 60 percent of its value is taxed as a long-term gain (maximum 20-percent tax rate) and 40 percent of its value is taxed as a short-term gain (which can be taxed at rates as high as 39.6 percent). A 475 election on this type of a gain would make it ordinary and eliminate the preferential tax treatment.

### Wash-sale rule:

A sale is considered to be a wash sale if it results in a loss and the item is purchased again within 30 days of the time it was sold. Under most circumstances, wash-sale losses cannot be taken as tax losses. Instead, the loss is carried forward to the next position of the same stock, option or commodity.

## HOW TO ELECT MARK –TO-MARKET (Excerpt from the: Traders Tax Solution)

Electing mark-to-market is an automatic election for a change in accounting principles and is done by filling out Form 3115. It is an automatic election; however, this form must be filed by certain deadlines. It also must be filed in duplicate, the first by itself with the national IRS office and the second attached to the tax return when filed.

For 1999, the election must have been made in all preexisting entities by the time the previous tax return was extended, or by April 15, 1999, for individuals and by March 15, 1999 for corporations. For new entities, a notation and a record must be placed in the corporation's board of directors minutes within 2 ½ months of the beginning of the tax year.

Strategy: If you have missed the election deadline for this year for the entity that you currently have, you can start a new entity and still elect Section 475. You can do this by putting it in the minutes within 2 ½ months of the beginning of the tax year. This means that if you are in the middle of 1999 and decide that you want to elect Section 475 you can form a new corporation and put a notation in the board of directors minutes within 2 ½ months of the beginning of the year in which you are making such an election.

The Traders Tax Solution- Book.

The one-stop guide to reducing tax liability for the serious trader and investor. 525 pages of all new information! You will find invaluable business, estate, retirement planning and tax-saving strategies that virtually anyone can implement. Included is specific information to help traders reduce their tax liability, with individual case studies, real-world examples, and model tax returns. Learn how to disinherit the federal government; how trader status is upheld, even under audit; how to use education tax breaks; how to augment under-funded retirement plans; how to master the basics of estate tax planning; how to use the annual gift tax exemption.....and much more!

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